



Commonwealth of Virginia

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P.O. Box 1295
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The Honorable James S. Gilmore, III
Governor of Virginia

The Honorable V. Earl Dickinson
Co-Chairman, House Appropriations Committee

The Honorable John H. Chichester
Co-Chairman, Senate Finance Committee

The Honorable Vincent F. Callahan, Jr.
Co-Chairman, House Appropriations Committee

The Honorable Stanley C. Walker
Co-Chairman, Senate Finance Committee

Gentlemen:

During our audits of Commonwealth's agencies and institutions, we have noticed a significant increase in contracting for services and have found several instances where decisions to contract services have been made without prior cost analysis. We surveyed 20 large agencies and institutions that have significant contracting and found that 50 percent do not perform any type of cost analysis before privatizing one or more of their agency's functions.

This lack of cost analysis seriously compromises any attempt to estimate the cost savings or other benefits resulting from a decision to contract with the private sector. We have concerns that agencies not performing sufficient research before making these decisions risk spending more on private contracts than they would to provide the service with state resources.

Our research has also found that agencies and institutions are not properly monitoring existing contracts to ensure adherence to cost savings estimates. The lack of systematic and comprehensive monitoring procedures also contributes to our concerns that agencies may be spending more on contracts with private providers than they would to perform these services in-house.

Finally, none of the agencies or institutions surveyed for this report had a methodology for identifying possible candidates for private sector contracting. These entities rely on employee and department recommendation to identify contracting opportunities. This method leaves out many prime candidates for contracting or changes in service delivery.

In conclusion, agencies and institutions should use either existing resources or the Commonwealth Competition Council methodology to develop a systematic, comprehensive, privatization process. Agency and institutions can use these methodologies to measure and select the appropriate opportunities for contracting.

The Auditor of Public Accounts appreciates the cooperation of all the agencies and institutions surveyed for this report, and also thanks the Commonwealth Competition Council and the Secretary of Administration for their comments.

AUDITOR OF PUBLIC ACCOUNTS

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INTRODUCTION

Our audits have found a significant increase in contracting for services. According to the Department of Planning and Budget's (DPB) January 1998 *Report on the Privatization Efforts of Executive Branch Agencies in the Commonwealth of Virginia*, state agencies entered into \$200 million in new contracts with private businesses from July 1994 to August 1997.

As the level of private sector contracting has increased, we have noticed recurring problems with how agencies approach privatizing services. During our audits, we have found several incidents where agencies have not appropriately researched decisions to contract or privatize agency services. This lack of research could allow for possible future cost increases or decreases in customer service levels.

Without performing sufficient analysis before contracting, agencies have no way of knowing how much, if anything, the Commonwealth saves from using private sector businesses rather than providing a service in-house. This lack of analysis also means that agencies do not have benchmarks against which to measure the level of service provided by a private contractor. As such, agencies can not reliably estimate the cost savings and benefits afforded through private sector contracting.

This report examines whether the Commonwealth's agencies have used best business practices in their decisions to open functions to competition. This Office is not questioning the use of private sector contracts; however, we believe agencies and institutions should carefully and appropriately research their decisions to privatize, and document the benefits to the Commonwealth so they can effectively identify and monitor contract service levels and costs. The report objectives are as follow.

- Do agencies and institutions evaluate the costs and cost savings associated with contracting out a service before making a decision to contract.
- Are agencies and institutions following up and evaluating privatized contracts to determine that the actual costs of privatization met original estimates.
- Do agencies and institutions monitor the service level of privatized services, make comparisons to previous service levels, and appropriately react to those comparisons.
- Do agencies and institutions have a systematic method for identifying services, which may be candidates for privatization or outsourcing.

The Auditor of Public Accounts conducted structured interviews in fourteen state agencies and six universities. The agencies and universities selected for inclusion in this review represented, in our opinion, agencies with the most potential for contracting.

These surveys asked targeted questions about the assessment of cost savings and other benefits of privatization, the monitoring of benefits provided by the private contractor, the extent of privatization or outsourcing within the agency/university, and the existence of formal and comprehensive procedures for selecting privatized functions.

SURVEY FINDINGS

Lack of Cost Savings Analysis

Our survey found that half of the agencies and universities did not perform any type of cost benefit analysis before contracting. Without cost analysis, agencies can not accurately estimate cost savings resulting from contracting a service. This, in turn, makes the estimation of overall savings due to contracting and privatization difficult and unreliable.

DPB's *Report on the Privatization Efforts of Executive Branch Agencies in the Commonwealth of Virginia* reported \$106 million¹ in savings from 151 privatized activities in the period from July 1994 to August 1997. DPB based their conclusion on the agency-reported service costs both before and after outsourcing. The findings of our survey indicate that agencies did not collect cost information before contracting services. Therefore, agencies and institutions submitting data to DPB may have collected information retrospectively and may not have had complete or reliable information. If agencies had conducted a comprehensive cost analysis before contracting, this process would have provided more reliable estimates of privatization cost savings.

Agencies and institutions have several tools available for estimating the costs of providing a service, the most notable is the COMPETE program from the Commonwealth Competition Council. The Council has distributed this software to every agency and institution and has offered training for agencies on an annual basis. While these tools are available, agency managers do not use them as part of the privatization decision process. None of the agency managers interviewed by our office mentioned the COMPETE software program when asked about their methods for analyzing potential cost savings under privatization.

Many agencies do not have the internal capability to perform the function they are considering for contracting, and therefore do not perform cost benefit analysis. The lack of internal agency capability to perform various functions stems from a variety of reasons including insufficient capital and personnel, as cited by 42 percent of the survey's agencies and institutions. Although not cited in every survey, many agency managers mentioned that decreased personnel from the Workforce Transition Act and subsequent hiring freeze required their agency or institution to use the private sector to provide mandated services.

In order to make valid contracting decisions, agencies must have the option of providing proposed services in-house. This option may involve adding staff, capital, or other resources, but if not considered, agencies may sacrifice lower service costs resulting from existing administrative capacity or infrastructure. Without the option of in-house provision, agencies will continue to make contracting decisions without regard to contract costs.

Lack of Formal Contract Review Procedures

An essential management function after the award of a contract is monitoring for quality assurance and on-going performance reviews. Without review, agencies cannot determine whether contractors are continuing to meet performance goals and maintaining their costs within estimates.

Of the 20 agencies and universities in this survey, only two universities have formal contracting review procedures that include both contractual requirements and estimated cost savings. George Mason University has developed annual contract review procedures for use throughout the University. Old Dominion University (ODU) has formal letters of understanding that define the roles of the contract administrators. ODU personnel overseeing the implementation of a private contract must sign these letters of understanding. Other universities, like many state agencies, are monitoring private contracts on a contract-by-contract basis.

¹ This amount included \$59 million in savings realized from the sale of the Virginia Education Loan Authority.

In our survey, seven of the thirteen agencies with private provider contracts perform monitoring on a contract-by-contract basis, with agency managers often assigned to the task of ensuring compliance with contract terms. While this arrangement allows for close monitoring of the contract by relevant personnel, agency managers may not have sufficient training or information available to fully evaluate whether the contractor meets all of the contract's requirements and estimated cost criteria.

Two of the remaining thirteen agencies monitor contractors, using the same mechanisms the agency used when it provided the function. Often, these procedures are informal or not well adapted to maintaining business contract environment that monitors requirements and costs. One state agency monitored contractors through an on-site liaison. The Department of Corrections has an employee on the site of its privately operated Lawrenceville Correctional Facility.

Agencies must develop comprehensive, agency-wide contract monitoring procedures to accurately assess the performance of contractors. This monitoring process needs to measure the success of the contractor in meeting pre-determined service goals and ensure compliance with cost objectives set during negotiation.

Lack of Identification Process

Our survey found that none of the respondents had a systematic, agency-wide approach to identify possible functions for privatization. None of the agencies surveyed performed reviews of all agency functions to identify those that may be good candidates for some form of privatization. Instead, most said that they identified privatization opportunities from manager and employee suggestions, a method that does not identify all potential candidates for privatization. Many agencies may be providing services better suited to come from privatize sources, but are unaware of these possibilities because they lack the means to identify them. Alternatively, functions identified for contracting may not provide the best means for that type of service delivery.

Agencies must adopt a methodology for evaluating the applicability of privatization to all agency functions. This methodology should include listing all agency functions and using a standard process to evaluate the delivery and cost of these services.

CONCLUSION

Agencies and institutions have increased their use of private sector contracting for a number of reasons. Regardless of the reasons for privatization, all agencies need to complete a comprehensive analysis before making decisions to contract services. Without this analysis and subsequent monitoring, agencies do not know if contracted services benefit the Commonwealth and its taxpayers.

List of Agencies and Universities Included in Privatization Survey

Department of Accounts
Department of Alcoholic Beverage Control
Department of Corrections
Department of Education
Department of Environmental Quality
Department of General Services
Department of Medical Assistance Services
Department of Mental Health, Mental Retardation and Substance Abuse Services
Department of Social Services
Department of Taxation
Department of Treasury
George Mason University
Norfolk State University
Old Dominion University
University of Virginia
Virginia Commonwealth University
Virginia Department of Health
Virginia Department of Transportation
Virginia Polytechnic Institute and State University
Virginia Port Authority

COMMONWEALTH OF VIRGINIA
AUDITOR OF PUBLIC ACCOUNTS
INTRAOFFICE MEMORANDUM

TO: Auditors Completing Privatization Questionnaire
DATE: August 18, 1998
SUBJECT: Completion of the Privatization Questionnaire

Privatization and outsourcing are among the biggest trends in government, and for that matter in business in general. The Auditor of Public Accounts has begun a project to review and evaluate the policies used to identify, evaluate, and monitor privatized and outsourced functions in state government. To begin this project, we will review these issues at some of the Commonwealths' larger agencies through the use of the enclosed questionnaire.

Although the questionnaire contains a description of the difference between outsourcing and privatization, we want to identify those activities that come under either definition. The privatization project is interested in statewide trends and oversight and not necessarily in individual agency activities.

In completing the questionnaire, you first should identify the individual at your auditee that coordinates these activities or an agency plan for privatization and outsourcing. This individual may be the fiscal officer or the budget manager. If it is difficult to identify all privatized and outsourced activities, you may want to consider whether the agency has a proper framework in place to identify activities for possible outsourcing or to monitor these contracts.

In addition to asking agency staff about these activities, there are other sources where you may be able to identify outsourced and privatized activities. CARS or agency accounting systems may contain information on contract payments to operate these activities. Colleges may have privatization and outsourcing schedules in their restructuring plans that they completed a couple of years ago and should be revising.

Please ask these questions in person and do not just give the auditee a copy of the questionnaire to "fill out." I appreciate your assistance in completing this project and in reporting to the Commonwealth's taxpayers and decision-makers the status of privatization and outsourcing in Virginia state government. Please have the questionnaires completed and returned by September 9.

encl: privatization questionnaire

Privatization Questionnaire

Privatization relates to any process aimed at shifting agency functions and responsibilities, in whole or in part, from the governmental agency to the private sector. Outsourcing is the hiring of private-sector firms or nonprofit organizations to provide goods or services for the government.

In outsourcing, the agency generally tailors the service to be provided to its own needs and retains responsibility for its effective completion. With these definitions in mind and considering the difference between outsourcing and purchasing a good or service, answer the next question as it pertains to the agency's current operations.

- I. Are there any functions that the agency has outsourced for more than five years? How long have these functions been outsourced? Examples of long-term outsourced functions include major road construction and Medicaid provider audits done by private firms.

The next set of questions relates to actual functions that the agency has privatized or outsourced. Questions 2 through 5 should be answered for each function identified in question 1.

1. Does the agency have any functions that it has privatized or outsourced in the past five years?
2. Why has the agency privatized these functions? When were these functions privatized? (When was the decision made and when did the vendor begin operations?)
3. How did the agency decide to privatize these functions?
 - What were the reasons that led to privatization of these functions?
 - What costs or cost savings were anticipated in the privatization decision? Were these amounts properly computed and documented?
 - What benefits were anticipated through privatization?
4. Has the agency reviewed these privatized functions after privatization was implemented?
 - Has the vendor complied with the terms of the contract?
 - Have the cost savings met the amounts anticipated in the privatization decision?
 - Have the customer service levels anticipated in the privatization decision been met?
5. Has the agency identified the benefits this privatization given the agency or its customers?

The next group of questions relates to the agency's policies and procedures and must be answered for all agencies identified in question 1 as having privatized functions. If the agency has formal, written procedures please include a copy of those procedures with the questionnaire.

- A. Does the agency have formal procedures to determine what functions should be reviewed for possible privatization?
- B. Does the agency have formal procedures to determine whether a specific function should be privatized?
- C. Does the agency have formal procedures to review privatized functions to determine whether the vendor has complied with the terms of the contract?
- D. Does the agency formally review to determine whether the cost savings anticipated in privatization were achieved?
- E. Does the agency formally review customer service levels to determine that the customer service levels anticipated in the privatization decision were met?